INDEX

	Page
PETITION:	
Caption, Salutation and Prayer for Writ	1
Judgment Below	1
Opinions Below	2
Jurisdiction	2
Questions Presented	2-4
Statutes and Constitutional Provisions Involved	4
Statement	4-9
Reasons for Allowing the Writ	9-11
BRIEF:	
Preliminary Statement	12
Specification of Error	12-14
Argument	
I Applicable principles in decisions of this Court	14-16
II Conflicting principle in decision of Court below	16-17
III Demonstration of conflict in decision of Court below	16-17
Appendix	28-29
STATUTES AND CONSTITUTIONAL PROVISIONS CITED:	
28 U. S. C. A. Section 347	2
Supreme Court Rule 38, Section 5(b)	2
Amendment V	4, 9
Internal Revenue Code, Sections 11, 12, 22(a), 181, 182, 3797(a) (1) (2)	4, 14-27
CASES CITED:	
Blair vs. Commissioner, 57 S. Ct. 330	10, 14
Burnet vs. Leininger, 52 S. Ct. 345	15, 19
Burnet vs. Wells, 53 S. Ct. 761	15, 19

INDEX—(Continued)

Page

Commissioner vs. Court Holding Company, 65 S. Ct. 707 19

Corliss vs. Bowers, 281 U. S. 376 ..... 15, 19

Commissioner vs. Tower, 66 S. Ct. 532 ..... 13, 15, 19, 23

Commissioner vs. Newman, 159 F (2) 848 18

Carl vs. Munter, 5 T. C. 39 23

DuPont vs. Commissioner, 53 S. Ct. 766 15

Earp vs. Jones, 131 F (2) 292 15

Gregory vs. Helvering, 55 S. Ct. 266 18

Griffith vs. Commissioner, 60 S. Ct. 277 18

Hoeper vs. Tax Commissioner of Wisconsin, 52 S. Ct. 170 ..... 9, 14, 22

Heiner vs. Donnan, 52 S. Ct. 385 ..... 10, 15

Helvering vs. Horst, 61 S. Ct. 144 ..... 10, 14, 15, 19

Helvering vs. Clifford, 60 S. Ct. 554 ..... 15, 19

Harrison vs. Schaffner, 61 S. Ct. 759 ..... 15, 19

Helvering vs. Eubank, 61 S. Ct. 149 ..... 15, 19, 21

Higgins vs. Smith, 60 S. Ct. 355 18

Kasch vs. Commissioner, 63 F(2) 466 23

Lusthaus vs. Commissioner, 66 S. Ct. 539 ..... 10, 13, 15, 19, 23

Lucas vs. Earl, 281 U. S. 111 ..... 14, 15, 19, 21

Lowery vs. Commissioner, 154 F(2) 448 23

Mauldin vs. Commissioner, 155 F(2) 666 10

Mead vs. Commissioner, 131 F(2) 323 ..... 15, 21, 23

Poe vs. Seaborn, 51 S. Ct. 58 ..... 14, 21

Scherf, et al vs. Commissioner, 161 F(2) 495 ..... 2, 13

Scherf, et al vs. Commissioner, 7 T. C. 346 2

Schroder vs. Commissioner, 134 F(2) 346 ..... 15, 19, 21

Saenger vs. Commissioner, 69 F(2) 631 ..... 19, 21

S. Kenneth Alexander, 6 T. C. 804 23

Villere vs. Commisisoner, 133 F(2) 905 ..... 19, 21

INDEX—(Continued)

Page

LEGAL PERIODICALS CITED:

"The Confusion on Family Partnerships," Georgia Bar Journal, May 1947, pages 353 et seq. 10, 11, 24

"Some Results of the Supreme Court Decisions in The Family Partnership Cases," Tennessee Law Review, December 1946, page 510 et seq.... 11

"Taxation of Family Partnership and Family Corporations," by Charles E. Works, The Rocky Mountain Law Review, April, 1947..... 11

In the Supreme Court of the United States

OCTOBER TERM 1947

No.....

JOHN G. SCHERF,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

GEORGE H. BARNES AND ADA E. BARNES,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable, The Chief Justice and Associate Justices of the Supreme Court of the United States:

John G. Scherf, George H. Barnes and Ada E. Barnes pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above causes on the 16th day of May, 1947, affirming decisions of The Tax Court of the United States. (R. 203).

OPINIONS BELOW

The Tax Court of the United States on the 11th day of July, 1946, made a finding of facts, rendered an opinion and on the 12th day of July, 1946 entered decisions denying Petitioners' petitions for redetermination of certain income tax deficiencies claimed of Petitioners, separately and severally, by the Commissioner of Internal Revenue for the year 1940. 7 T. C. 346.

On review by the United States Circuit Court of Appeals for the Fifth Circuit that Court affirmed. *Scherf vs. Commissioner,* etc., 161 Fed. (2) 495.

JURISDICTION

Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925. 28 U. S. C. A., Section 347, Section 5 (b) of Supreme Court Rule 38, and Section 1141 of the Internal Revenue Code.

Judgment of the Fifth Circuit Court of Appeals was entered May 16, 1947. Application for Rehearing was denied June 17, 1947. This petition was filed within ninety days after judgment denying Rehearing was entered. (R. 212).

QUESTIONS PRESENTED

1. Whether Petitioners are taxable on all of the income of a partnership, (the income from which is not derived from personal services), where gifts of interests in a business, property and assets are made to their children and a partnership agreement between all of the owners of the assets of the business is then executed which recognizes the ownership of each party, and Petitioners neither retained any rights of ownership, expressly or secretly, over the transferred interests and assets, nor received, used, enjoyed or in any manner obtained the benefit of income arising therefrom.

2. Whether

the gift of an interest in valuable capital assets of an unincorporated business and subsequent agreement for operation recognizing the donee's ownership interest therein, without any dominion, control or command by donor over the property and income therefrom equivalent to economic ownership,

is an "arrangement *merely* for the purpose of enabling (donor) *to reduce* (*his*) *taxes on* future income from *donor's business* by dividing *the income* with donee, (*lacking substance*),

solely because the gift was *not* made and the agreement entered into by donor *"with the purpose, expectation or result of obtaining economic or business advantages" for himself.*

3. Whether Respondent can refuse to recognize bona fide ownership of interests in the capital and income of a non-personal service partnership and tax Petitioners with the income therefrom *solely because such interests in the partnership capital and business were acquired as gifts from Petitioners, even though*

(a) There is no sham and pretense involved.

(b) Petitioner retained no such rights of dominion, control and command over partnership capital and income therefrom as would be the economic equivalent of ownership.

(c) Petitioner neither received, nor enjoyed, economic benefits from such income in any way.

(d) There was a complete change in the *legal* and *economic* relation of Petitioner and his sons to the income in question.

(e) The sons were entering upon business careers—one married and maintaining separate household.

STATUTES AND CONSTITUTIONAL PROVISIONS INVOLVED

Internal Revenue Code, Sections 11, 12, 22 (a), 181, 182, 3789 (a) (1) (2), Constitution of The United States, Amendment V. See Appendix.

STATEMENT

Respondent charged Petitioner Scherf with income tax deficiencies for the year involved in the amount of $4,498.75, and Petitioner Barnes and wife were charged with deficiencies for said year in the amount of $4,125.00, on the ground that Petitioners were taxable not only on their own income, but also on the income their respective sons and daughters received from a partnership business conducted in Andalusia, Alabama, under the firm name of S. & B. Manufacturing Company. Each of the sons and daughters reported their respective shares of the partnership income for the year involved and paid the income tax chargeable to each of them, respectively.

Petitions for redetermination were filed by Petitioners in The Tax Court of the United States. The cases were consolidated for hearing in that Court, with one finding of fact and opinion, but separate decisions. On joint motion and order of Court only one transcript of the Record was filed in the Circuit Court of Appeals and one judgment was rendered in that Court.

The facts were not in dispute. Briefly stated they are as follows:

From November, 1938 until May 15, 1940 Petitioner Scherf with his partner George H. Barnes, engaged in the

manufacture and sale of work pants under the firm name of S. & B. Manufacturing Company. The partnership business employed about two hundred employees, including machine operators, examiners, pressers and foremen. *There was also a plant foreman, Mr. Carmack, who was under the supervision of Mr. Thompson, general factory superintendent.* (R. 150). Each partner owned an undivided one-half interest in the business. Petitioners were also officers, directors and stockholders, in two other garment manufacturing companies, the Alabama Textile Products Corporation and The Andala Company. Alabama Textile Products Corporation manufactured dress shirts and shorts. The Andala Company manufactured work shirts. A joint office was maintained for all three companies, which were under common top management.

Petitioner Scherf had long planned to bring his sons up in the garment manufacturing businesses in which he was interested and eventually have them take over their management. (R. 140, 143). *In the latter part of* 1939 *he discussed with his son, Paul, (who was at that time employed by and working with Alabama Textile Products Corporation) the formation of a new partnership for S. & B. Manufacturing Company, in which Paul would become a partner.* (R. 173). Later in the same year Petitioner Scherf discussed the matter with his partner, Barnes, at which time he proposed the formation of a new partnership with his sons Paul and John as partners. (John was in college at that time, *but was insisting on quitting school and going to work.* (R. 139). Barnes agreed to the proposed new partnership, but asked to bring in his two daughters, Mildred and Ruth.

On May 16, 1940 Petitioner Scherf transferred to his sons, Paul and John, and Petitioner Barnes to his daughters, Mildred and Ruth, by written assignments, a one-sixth interest each in the business, assets and property of

S. & B. Manufacturing Company[1] and thereafter all of the parties executed a written partnership agreement for further conduct of the business by the new partnership.[2]

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1. "In consideration of love and affection the undersigned J. G. Scherf, owner of an undivided one-half (1/2) interest in the partnership business and assets of S. & B. Manufacturing Company, a partnership composed of J. G. Scherf and George H. Barnes, does hereby give, assign, transfer and convey unto Paul W. Scherf as a gift, an undivided one-sixth (1/6) interest in the business of said partnership doing business in building known as Benson Hardware Building in Andalusia, Alabama, including all the stock, raw material and finished products, machinery, equipment, fixtures, accounts and all other assets of said partnership of every nature and kind whatsoever, including the leasehold interest on the premises in which said business is now conducted.

To Have and To Hold said goods, chattels, property and interest unto said Paul W. Scherf, his heirs, executors, administrators and assigns, to his own proper use forever."

(Note: Transfer to others in same language and figures except change in name of grantee.)

"The S. & B. Manufacturing Company had assets at the close of the year 1939 of the total amount of $47,163.15, and its net worth as shown by its balance sheet was $32,321.50. The assets included about $25,000.00 worth of machinery and equipment and $20,000.00 of cash and accounts receivable."

2. By the terms of the partnership agreement all owners of the capital assets agreed to "be and become partners" in the operation of S. & B. Manufacturing Company, a business engaged in the manufacture and sale of work pants; that "each partner shall share equally in all the profits and losses"; that Petitioners Scherf and Barnes would be managing partners, with Petitioner Scherf in charge of the office and finances of the business and Petitioner Barnes as manager in all things pertaining to manufacture and operation of the plant but with general control *in all of the partners* ("a majority of the partners shall be authorized to determine all questions as to the conduct of the partnership business"); partnership funds could be withdrawn by check only by Petitioner Scherf or his authorized agent but at the end of each year "the accrued profits of said business as shall appear by the books *shall be* equally divided between the said parties *and withdrawn from said business*", or all or a part of such profits "might be added to the original capital *by agreement between the parties*". Each partner con-

Petitioner Scherf filed a gift tax return, *reporting the gifts and Respondent subsequently assessed a deficiency gift tax for* 1941 *because of a revision in value of the partnership interest transferred.* (R. 185, 186). John and Paul Scherf each filed a donee's information return of the gifts covered by the assignments to them. Petitioner Barnes also filed gift tax returns and paid the tax thereon.

At the time of the gift and partnership agreement, Paul Scherf was twenty-eight years of age, married, maintained a separate household and was actively working in Alabama Textile Products Corporation, one of the garment manufacturing businesses operated under common top management with S. & B. Manufacturing Company. John Scherf was twenty years of age and attending college *but had insisted on quitting school and going to work in the garment business,* which he did at the end of summer school in 1940. At the time of the trial he was married and serving in the United States Army Air Corps overseas.

Capital accounts were set up for all of the parties on the books of S. & B. Manufacturing Company in accordance with the partnership agreement. *Withdrawals were made by each of them which were deposited in their own personal bank accounts. Petitioner Scherf exercised no control, restraint or direction over the use of funds withdrawn by his sons, Paul and John, and had no right to do so; except as to John, during his term of army service, when Petitioner made such withdrawals and deposits for him under a written power of attorney and acting as his attorney in fact. The funds withdrawn were used for their own personal purposes.* (R. 173).

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tributed one-sixth of the partnership capital, the contribution of Paul Scherf, John Scherf, Mildred and Ruth Barnes, being the property, interest and assets received from Petitioners as gifts by the above assignments.

A table showing total of credits for distributive shares of income and total actual withdrawals is set out below.[1]

Neither of Petitioners alone had or acquired control over the partnership business other than such control as he might exercise through his position as one of the managing partners with duties specifically assigned by the partnership agreement. The managing partners were fully accountable to all members of the partnership and general control of the partnership business was vested in "a majority of the partners". (R. 19).

Until the latter part of the year 1940 the activities of Paul Scherf in the partnership business were limited "to learning about the business and keeping some personnel files." After he became a member of the partnership a personnel office was established, which was charged with the keeping of complete files on all employees of the partnership, the supervision of employee life insurance, the operation of a suggestion system, the handling of personal matters for employees, the direction and operation of a musical system, the supervision of employee production records and the general supervision of personnel work. *Paul Scherf was in charge of this personnel office and held weekly conferences with reference to the operation of the business as to make up and cutting problems.* (R. 172A).[2]

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1. (1940-1944)

Credits of Income	*Actual Withdrawals*
$38,221.28—Paul	$27,467.67
38,221.28—John	27,467.67
38,221.28—Petitioner Scherf	27,467.67
38,221.28—Mildred	27,467.67
38,221.28—Ruth	27,467.67
38,221.28—Petitioner Barnes	27,467.67

2. Paul Scherf, now in charge of the Department of Industrial Relations for all companies, has made an outstanding record in this field. See "Southern Garment Manufacturer", June 20, 1947, pages

John Scherf was employed in the joint office maintained for all three companies and did billing work for S, & B. Manufacturing Company *until he began his army service* in 1942. (R. 143, 139).

Mildred and Ruth Barnes were twenty and eighteen years of age respectively, and were attending college. They are now married and have their own families.[1]

REASONS FOR ALLOWING THE WRIT

(1) The Circuit Court of Appeals for the Fifth Circuit has decided this case in a way in direct conflict with applicable decisions of this Court, because

(a) It imposes on Petitioners an income tax measured by income from property owned by other taxpayers, contrary to the Fifth Amendment to the Constitution of the United States and the decision of this Court in *Hoeper vs. Tax Commission of Wisconsin,* 52 Sup. Ct. 120.

(b) It establishes the following proposition as a conclusive presumption of law viz: If a taxpayer transfers an interest in the capital assets of an unincorporated, non-personal service business *as a gift,* without any "purpose, expectation, or result of obtaining economic or business advantages" for himself, then the *gift* is without *substance,* is a sham and pretense, made "for the purpose *merely* of enabling the taxpayer to *reduce his*

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14 et seq. The article refers to an employee handbook issued by Alabama Textile Products Corporation. The same handbook was issued for S. & B. Manufacturing Company, the partnership, and the same character of personnel work was done for the partnership.

1. No reference was made by the lower Courts as to the facts set out in italics, or underscored, although such facts were established by the undisputed evidence in the case. The other facts are incorporated in the findings of fact by The Tax Court.

taxes from *his* business by dividing *his* income with the donee. Such conclusive presumption is in conflict with *Heiner vs. Donnan,* 52 Sup. Ct. 385, and ignores the lawful rights of citizens to transfer property *by gift.*[1]

(c) The decision affirms the startling and "peculiar Tax Court notion" that a *gift* of a partnership interest to a member of the donor partner's family cannot be recognized for income tax purposes *as a matter of law* and is in conflict with *Commissioner vs. Tower,* 66 Sup. Ct. 532; *Lusthaus vs. Commissioner,* 66 Sup. Ct. 539;[2] *Blair vs. Commissioner,* 57 Sup. Ct. 330 and *Helvering vs. Horst,* 61 Sup. Ct. 144.

(2) This case involves one of the most vexatious problems in the tax law of our time. Numerous cases are now pending in The Tax Court, the District Courts and in the various Circuit Courts of Appeal involving the prin-

1. "The peculiar Tax Court notion that a gift of a partnership interest to a member of the donor partner's family cannot, as a matter of law, be recognized for income tax purposes has produced startling results in the income tax field. . . . Although the District Courts and the Fifth Circuit Court of Appeals seem to understand the limitation of the very narrow holding of the *Tower* case, *it is to be hoped that the Supreme Court will soon find occasion to correct the pattern which The Tax Court is constructing on the basis of its own misinterpretation of that decision.*" "The Confusion On Family Partnerships"—Georgia Bar Journal, May, 1947.

Unfortunately, since this article was written, the Fifth Circuit Court in the cases at bar has joined in "the pattern of misinterpretation", as had the Fourth Circuit in *Mauldin vs. Commissioner,* 155 Fed. (2) 666, against dissent by Judge Timmerman.

2. In these cases "the Court was applying old doctrines to the partnership relation rather than establishing any new principles. Nevertheless . . . the broad language used has encouraged lower Courts *to go beyond the actual decisions of those cases*". The decision of the Fifth Circuit in the case at bar goes so far beyond *Tower* and *Lusthaus* as to enter a radically new realm of judicial legislation beyond the pale of the Constitution.

ciple under consideration, directly or indirectly. A pattern of unconstitutional confiscation is being frozen under the form of cliches. Clear cut legal principles used by this Court in the decisions of the *Tower* and *Lusthaus* cases and their field of application have been confused and transformed by adulteration and improper amalgamation.

See: "The Confusion On Family Partnerships", by Elbert P. Tuttle and James A. Wilson, Georgia Bar Journal, May, 1947, pages 353 et seq.

"Some Results Of the Supreme Court Decisions In The Family Partnership Cases", Tennessee Law Review, December 1946, pages 510, et seq.

"Taxation of Family Partnership and Family Corporations", by Charles E. Works, The Rocky Mountain Law Review, April, 1947.

The general situation prevailing in the Courts and administrative agencies imperatively demands an immediate correction by this Court of the "pattern of misinterpretation" now existing.

(3) The decision of the lower Court is obviously in error, as demonstrated in the annexed Brief.

For these reasons, as demonstrated in supporting Brief, it is respectfully submitted that this Petition should be granted.

Attorney for Petitioners.

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In the Supreme Court of the United States

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GEORGE H. BARNES AND ADA E. BARNES,
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BRIEF FOR PETITIONER

STATEMENT

The material facts, the questions involved, the jurisdiction of this Court and the opinions of the lower Courts are set forth in the foregoing Petition.

SPECIFICATION OF ERRORS

The Tax Court of the United States stated in its opinion:

"Where a husband and his wife, or a husband and his wife and children, enter into a partnership arrangement

and it appears from the facts that the wife and children made no investment of capital *originating with them,* that they had no voice in the management or control of the business, and that they contributed no vital services, *those circumstances* will justify this Court in concluding that a real partnership between them and the husband and father does not exist insofar as the Federal income law is concerned."

The Tax Court then found that the children contributed no capital *originating with them,* contributed nothing to the management, or control of the business, rendered no vital services during the year 1940 and on this basis reached the conclusion "that in 1940 there was no real partnership between the Petitioners and their children for Federal income tax purposes."

The Fifth Circuit Court of Appeals stated in its opinion:

"The Tax Court found that the arrangement taxpayers had made, though taking the form of a partnership had not in fact resulted for Federal income tax purposes in creating one, *because* they had been entered into not with the purpose, expectation, or result of obtaining economic or business advantages, but for the purpose merely of enabling taxpayers to reduce their taxes on future income from their business by dividing the income with their children. On these findings and on the authority of Commissioner vs. Tower . . . 66 Sup. Ct. 532 . . . and Lusthaus vs. Commissioner . . . 66 Sup. Ct. 539 . . . it sustained the Commissioner's determination. . . .

"Here Barnes neither needed nor obtained the services, skill, money or credit of his minor daughters. On the face of the record they had none to contribute. Needing and receiving from them none of these essentials to the formation of a business partnership, needing only to

divide his income from the business with them, Barnes confected this arrangement for the sole purpose of doing so. The record standing thus, as to Barnes, it is upon the plainest principle manifest that the findings and order of The Tax Court as to him were not merely supported but were demanded, by the evidence . . . Scherf's case, while making a little better appearance, is in its substance the same. It is true that those with whom he chose to divide his earnings were adult sons, one of them already in business and capable of being a real partner, but it is equally true that *in the tax year in question* neither of the sons furnished or expected to furnish the business any new capital or skill, or any new or substantial service, and that the facts in this case add up to nothing more than an arrangement where after May 16, Scherf would divide with his sons, as Barnes would divide with his daughters, his share of the earnings from the business."

This is a clear cut adoption of "the pattern of misinterpretation"—"that peculiar Tax Court notion" that a *gift* of a partnership interest to a member of the donor partner's family cannot be recognized for income tax purposes *as a matter of law,* and constitutes manifest error which should be corrected by this Court, because

ARGUMENT

The decisions of this Court require the taxation of income from *personal services* to *the earner, Lucas vs. Earl,* 281 U. S. 111; the income from *property* to the *owner* of the property; *Helvering vs. Horst,* 61 Sup. Ct. 144. *Blair vs. Commissioner,* 57 Sup. Ct. 330.

The income tax imposed on one taxpayer cannot be measured or fixed by income from personal services rendered or property owned *by another taxpayer. Hoeper vs. Tax Commission of Wisconsin,* 52 Sup Ct. 120; *Poe vs.*

Seaborn, 51 Sup. Ct. 58; *Heiner vs. Donnan,* 52 Sup. Ct. 358.

No device, or arrangement "can make earnings from personal services taxable to any but the real owner of them in the first instance, or can make future income from property taxable to any but the owner of the right or title from which the income springs". *Lucas vs. Earl,* supra; *Helvering vs. Clifford,* 60 Sup. Ct. 554; *Harrison vs. Schaffner,* 61 Sup. Ct. 759; *Helvering vs. Eubank,* 61 Sup. Ct. 149; *Helvering vs. Horst,* 61 Sup. Ct. 144.

In determining who is the earner of income the Court looks to *substance,* not *form.* Therefore—

Income from *personal services* cannot be diverted through the form of a partnership contract, *Earp vs. Jones,,* 131 Fed. (2) 292; *Mead vs. Commissioner,* 131 Fed. (2) 323, *Schroder vs. Commissioner,* 134 Fed. (2) 346; any more than by direct assignment, *Lucas vs. Earl,* supra, *Helvering vs. Eubank,* supra. Nor can the partnership form be used for the diversion of income from the utilization of property or capital where the party seeking to divert the income retains dominion, command and control over the partnership capital and the income therefrom to such an extent as to hold the economic equivalent of ownership, *Lusthaus; Tower; Helvering vs. Clifford; Harrison vs. Schaffner; Corliss vs. Bowers; Burnett vs. Wells; Du Pont vs. Commissioner,* any more than by a *sub-partnership* agreement *without any transfer of assets. Burnett vs. Leininger,* 52 Sup. Ct. 345.

Therefore, the basic statement of the law by this Court, governing taxation of income from partnerships where one partner transfers an interest in the partnership business by gift to a member of his family is: If the income from the partnership business is not derived from personal services, and

(a) The transfer of an actual interest in the property and capital of the business is in good faith—not pretense or sham, and

(b) the transferring partner (donor) *does not* reserve or retain dominion, command and control over the partnership capital and the income therefrom, or enjoy the economic benefits of the income

then the transaction has substance and the income from the partnership business is attributed to the owners of the property and capital used in the business *to the extent of such actual ownership.* As to whether or not the transfer is in good faith, without retention of dominion, command and control of the capital and income therefrom, or enjoyment of the economic benefits of the income, depends upon (a) the partnership agreement considered as a whole and (b) the conduct of the parties in the execution of its provisions. Transactions with members of a family are closely scrutinized.

BUT, the decision of the Fifth Circuit Court in the case at bar simply says, there can be *no substance* to the transfer of an interest in partnership capital and property *by gift* from parents to children, because—

Transfer of an interest in partnership capital and property (consisting of cash, machinery, inventories, accounts receivable, etc.) *must* be made with "the purpose, expectation or result of obtaining economic or business advantages" (*new capital, services, managerial wisdom*) —not as *a gift;* otherwise, as a matter of law there is no *substance* to the transaction and it becomes "merely an arrangement for reducing taxes on future income from the business by dividing the income with the children."

We submit that an actual, bona fide ownership interest in the cash, machinery, inventories, accounts receivable and other assets of a business, can be acquired *by gift,* without

the purpose, expectation or result of obtaining economic or business advantages *to the donor,* but for the very opposite purpose of vesting such advantages *in the donee,* just as such ownership may be acquired by gift of an interest in a building, a trust estate, stock in a corporation, bonds, automobiles, oil royalty pools, or any other kind of property. To hold otherwise is arbitrary confiscation, imposing on one taxpayer a tax measured or fixed by income from the property of another in violation of the Fifth Amendment to the Constitution and "those fundamental conceptions of free government which underlie all constitutional systems". It is contrary to all of the decisions of this Court. It is a diversion to "the purposes of the community" of the property of a citizen, under the outer *form* of a legal cliche.

This is the only question involved here. All other factors or questions were determined in favor of Petitioners, or were not considered by the lower Courts.

The mere fact that the gift was not made "with the purpose, expectation, or result of obtaining economic or business advantages" is immaterial, if there was an actual, bona fide *transfer of ownership* of the *capital,* or *an interest in capital* of the partnership. Arrangements of individuals made "for the purpose *merely* of enabling taxpayers to reduce their taxes on future income" necessarily imply one of two things: (a) That the income is from *personal services,* or (b) that the taxpayer attempts to obtain the benefit of splitting income from *property,* or an interest in *property* by means of a trust, transfer, or partneship form, *without losing dominion and control over the corpus of the property and the income therefrom.* It should be a commonplace of the law in a free country that a citizen cannot be taxed "with respect to the income from a corpus definitely and finally transferred to another person." Such an attempt crosses the dividing line between lawful taxation and unconstitutional confiscation.

"Over and over again Courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." *Commissioner vs. Newman,* 159 Fed. (2) 848.

Hence, if Petitioners desired to reduce their income taxes by conveying all or a part of their income producing *property* they had the legal and moral right to do so: provided, they did not retain dominion and control over the property and income, or the gifts and resulting partnerships were not sham and pretense.

The "business purpose" doctrine simply requires *substance* for transactions under Federal statutes. If it is a business transaction, personal transaction, or any other kind of transaction that leaves the parties in the same situation, the same economic relation to income and property, as they occupied before the transaction, then there is a lack of reality sufficient to permit the transaction to be entirely disregarded. That is all that is contained in the "business purpose" concept. There must be "*substance*" in the transaction in order to sustain it for tax purposes.

Gregory vs. Helvering, 55 S. Ct. 266;
Higgins vs. Smith, 60 S. Ct. 355;
Griffiths vs. Commissioner, 60 S. Ct. 277.

An example in the family partnership field is: where the donor of an interest in the partnership property retains dominion, command and control over the partnership property and the income therefrom and receives, uses or enjoys the benefit of the income, then the transfer lacks *substance* and the transaction may be entirely disregarded for tax purposes. The parties remain in the same situa-

tion, the same economic relation to the property and income, as they occupied before the transaction, *Commissioner vs. Tower,* 66 S. Ct. 532; *Lusthaus vs. Commissioner,* 66 S. Ct. 539.

Such is not the case at bar—nor did the lower Courts so hold.

The cases cited by the Fifth Circuit Court of Appeals to sustain its decision are not applicable; *Lucas vs. Earl,* 281 U. S. 111; *Burnett vs. Leininger,* 285 U. S. 136; *Helvering vs. Eubank,* 311 U. S. 122; *Saenger vs. Commissioner,* 69 Fed. (2) 631; *Villere vs. Commissioner,* 133 Fed. (2) 905; *Schroder vs. Commissioner,* 134 Fed. (2) 346, nor are *Commissioner vs. Court Holding Company,* 65 S. Ct. 707, *Helvering vs. Horst,* 61 S. Ct. 144. These cases either involve income derived from personal services, or from transfers of property where the tax incidence *attached to the earner or the owner before the income could flow into another.* In other words, the income inured to the person against whom the tax was assessed before it was channeled to the other parties by assignment of income or transfer of property.

Corliss vs. Bowers, 281 U. S. 376; *Harrison vs. Schaffner,* 312 U. S. 579; *Helvering vs. Clifford,* 60 Sup. Ct. 554; *Burnett vs. Wells,* 58 Sup. Ct. 761 and related cases, all involve control, dominion and command over the property transferred and the income therefrom to the extent equivalent to economic ownership.

In the case at bar, "the partnership agreement considered as a whole" and "the conduct of the parties in the execution of its provisions" fully sustained the partnership for tax purposes, under the undisputed evidence. The sole basis for the conclusion of the lower Court was that no business purpose was served by the gifts of interest in the partnership capital, that is, the gifts and partnership

agreement were not made and entered into by Petitioners "with the purpose, expectation or result of obtaining economic or business advantages" for themselves. Therefore, said the Court, the arrangement was made "*merely* for the purpose of enabling taxpayers *to reduce their taxes* on future income from *their* business *by dividing the income* with their children." This conclusion is not justified by its premise, unless

(1) Petitioners, by secret agreement or understanding, retained to themselves such valuable rights of ownership that, when they wished, they might use the partnership property and earnings as their own, or

(2) The gift of the business assets was made with the understanding that they be placed in a partnership under an agreement giving Petitioners personal rights which were the economic equivalent of ownership and inconsistent with the theory of a partnership of several owners.

Neither of these factors were found to exist by the lower Courts. They do not exist. There were actual transfers of property, without retention of ownership rights and privileges. This is decidedly something more than an arrangement "merely . . . to reduce . . . taxes." It may and does reduce taxes. But more than that, it reduces the *assets* and *property,* the wealth and capacity, which produce the income giving rise to the taxes. The doctrine of the lower Courts prohibits the diversion, not of income but of wealth—assets, from "the purposes of the community" to one's own children. That is a strange doctrine in this land. It is based on the premise of the total State.

Of course, a partnership may not be recognized for tax purposes, if it has no substance or reality as a partnership and is merely an attempt to make "a paper reallocation of the family income for tax purposes". Was it intended that

the party receive income from the partnership business because of bona fide ownership of an interest in the partnership assets and business;[1] or was it intended to divert the *income* and *tax incidence* of some of the parties to the others under the outward form and guise of a partnership? Intention in this respect is a question of fact to be determined from (a) "their agreement, considered as a whole", and (b) "their conduct in the execution of its provisions".

Obviously, if all persons are bona fide owners of interests in the capital of the non-personal service partnership, as shown by the agreement and their conduct in the execution of its provisions, then they are entitled to the income *properly allocable* to such interests owned, and should be taxed accordingly. In such cases, there can be no diversion of *income* and tax incidence thereon from some of the partners to the others. The fruit is not separated from the tree whereon it grew. None of the parties were entitled to the allocable share of the other *in the first instance*, that is, at the time the income was earned.

Under the Constitution, it cannot be taxed otherwise.[2]

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1. Since the income of the partnership business in this case was not derived from the personal services of Petitioners, the general discussion is based on the right of the other partners to receive a share of the income because of a *bona fide ownership* of an interest in the property, assets and business of the partnership as a capital asset—a *bona fide* contribution to capital. We readily recognize the principle that a person cannot assign or transfer future earnings from personal services under the guise of forming a family partnership, even though the assignment may be legal and valid under State law. *Lucas vs. Earl*, 281 U. S. 111, *Helvering vs. Eubanks*, 61 Sup. Ct. 149; *Saenger vs. Commissioner*, 69 Fed. (2) 631; *Villere vs. Commissioner*, 133 Fed. (2) 905; *Schroder vs. Commissioner*, 134 Fed. (2) 346; *Mead vs. Commissioner*, 131 Fed. (2) 323.

2. The income tax statutes tax the "net income of every individual". Section 11, 12, Internal Revenue Code The word "of" denotes ownership. *Poe vs. Seaborn* 51 Sup. Ct. 58. "The underlying message of

Therefore, the question at issue in these non-personal service partnerships can only be solved by an examination of the facts to determine whether or not (a) the agreement of the parties considered as a whole and (b) their conduct in the execution of its provisions, disclose bona fide ownership of an interest in the capital and business of the partnership and allocation of the income in accordance with such interest owned. If so, there was an intention to "really and truly . . . join together for the purpose of carrying on business and sharing in the profits or losses, or both" on the basis of ownership. Res ipsa loquitur.

Bona fide ownership does not exist where it is a matter of form, or sham, without substance, or where dominion and control over the property and income is retained by a donor who is receiving the benefit of the income so that he is substantially in the position of an owner.

Hence all decisions have heretofore adhered to this fundamental concept: Income should be taxed to the persons entitled to receive it by the partnership agreement, unless the agreement is sham and not real, or unless it will result in shifting income to others from either personal effort, or from property owned by him or property over which he has retained dominion and control in his own personal right so as to enjoy the income therefrom.[1] BUT, The Tax Court and the Fifth Circuit Court of Appeals have added

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all the cases is that the ownership of *capital* identifies *the taxpayer* for purposes of the tax on the income therefrom, and the law cannot make a different rule for . . . parent and child from the rule which obtains with respect to other parties equally separate in the eyes of the law". (Mertens) Nor can the income tax imposed on one individual be measured by the income of another. *Hoeper vs. Wisconsin*, supra.

1. Rights substantially equivalent to economic ownership appear in varying constellations when viewed through the catalytic agency of intention to avoid taxes: Examples—

a startling and novel twist to this accepted doctrine. These Courts hold that if the ownership of the interest in the capital and business of the partnership was acquired by *gift*, there arises illegal diversion of income and tax incidence from the donor to the donee, even though the gift vested in the donee *full rights of ownership* and the donor has not expressly (by the instrument of gift or the partnership agreement), or secretly (by his conduct in the execution of its provisions, manifesting contrary intention) retained to himself any of the rights of *an owner* over the transferred interest and capital.[1]

Tower—Lusthaus—Control over time and manner of distribution of income, with *full* control of the business and actual *receipt* of the income, or *use* of same for common enjoyment.

Kasch vs. Commissioner, 63 Fed. (2) 466—No right to withdraw profits by donee, full control of business by donor.

Mead vs. Commissioner, 131 Fed. (2) 323—No drawing account for donee and "unlimited authority to conduct (business) as (donor) desired."

Lowery vs. Commissioner, 154 Fed. (2) 448—Full right of donor to exhaust entire income by his salary—no profits to be distributed except by mutual consent.

Carl P. Munter—Full right to fix salaries—no right of donee to sell except by consent—no right in donee to assign or charge income or profits—reversionary interest retained to donor.

S. Kenneth Alexander—Trust—Grantor-trustee in full control, Beneficiary could not assign, anticipate or pledge either income or corpus and income payable to beneficiary at will of trustee.

The variations are numerous, but whatever the factors may be they must measure up to a legal concept, viz: dominion and control over the income or its use and enjoyment, before economic ownership can be separated from title or contractual right.

1. "The error of The Tax Court (and Fifth Circuit Court of Appeals) in . . . application of the *Tower* case lies chiefly in . . . failure to recognize the validity of a contribution to capital . . . (where a gift of valuable business assets is made with the understanding that they be placed in a partnership under a partnership agreement recognizing the ownership of each partner, and the transferor has not expressly or

The theory of this holding is that since the donee does not furnish any *new* capital, services, skill, money or credit to the partnership, no "business purpose" is served by the gifts. Since no *"business purpose"* is served by the gift "the facts . . . add up to nothing more than arrangement" for the diversion of income and tax incidence from the donor to the donee, which will not be recognized for income tax purposes. They say that in such cases the partnership form is being used "as a device for separating the tree from its fruit, the earner from the income", as a matter of law.

We respectfully submit that this doctrine of the lower Court completely ignores the following basic principles of constitutional and tax law:

1. Where the income arises from the utilization of property, then such *property is the tree.* Therefore, as to a partnership the income from which is not derived from personal services, the effect of the decisions of the lower Court is either that—

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secretly retained to himself any of the rights of an owner of the transferred assets). It is a rather startling rule that The Tax Court (and Fifth Circuit Court of Appeals) deduces from the *Tower* case. Certainly, there is no question but that an individual can make a gift of property which is valid for all purposes, including Federal taxes. The owner of property now encounters an entirely different and novel rule, however, when he endeavors to dispose of some part of a capital interest which he has in an unincorporated business. After the gift, the operation of the business without incorporation necessarily requires a partnership agreement, and The Tax Court (and the Fifth Circuit Court of Appeals), interpreting the *Tower* case as holding that a partnership interest may not be created by gift, upholds the Commissioner in taxing to the donor earnings on the capital he has given away. This principle seems unsound and should not be accepted unless clearly required by controlling decisions." The Confusion On Family Partnership" by Elbert T. Tuttle and James H. Wilson, Georgia Bar Journal, May, 1947, page 355.

No controlling decisions so require.

(a) An interest in partnership property and business *is not property—not a tree,* or

(b) An interest in partnership property and business *cannot be transferred.*

Either it is not the tree, or an interest in the tree cannot be transferred so as to create a corresponding interest in the fruit.

Since the income from the partnership business is not derived from personal services of the partners, but from utilization of the partnership capital and operation of the partnership business, the partnership capital and business must be the tree. In this respect there can be no difference between a corporation and a partnership where they are engaged in the same character of business.[1]

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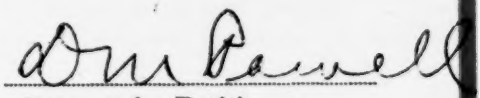
1. The Circuit Court of Appeals misconceived the significance of our argument in this respect. We recognize all that the Court says concerning the difference in tax structures for partnerships and corporations; that partnerships are not recognized or taxed as entities separate from the partners; that partners are taxed only in their individual capacities on their distributive shares of net income from the business, whether distributed or not; that a partnership for tax purposes is neither more nor less than an aggregation of individuals who have pooled . . . capital (or skill, services, or all three) for the purpose of making individual income; that a corporation is taxed on its earnings and the stockholders are taxed only on dividends distributed to it. *But,* in considering the question as to whether or not *capital* and the *business* is the tree upon which the fruit grows, there can be no distinction between a corporation and a partnership engaged in the same business. Where the business is not of a personal service nature, the income must arise from utilization of *the capital as a pooled entity,* i.e. the business. Capital is pooled in the corporate business. Capital is pooled in the partnership business. Some or all of the stockholders may render services to the corporate business, or none of them may do so. *Some, or all of the partners may render services to the partnership business, or none of them may do so.* The fact that there is a difference in taxation of corporations and partnerships is entirely without significance. The business *is not a corporation.* It cannot be taxed as a corporation. There-

fore, the individuals interested in the business must be taxed on the basis of their bona fide *ownership interests* in the business. The fact that the government does not get a double tax is irrelevant to the question. That is the way Congress wrote the Revenue Act and set up the tax structure. Neither the Circuit Court of Appeals nor any other Court, can change that, nor can they deny the efficacy of the transaction because a double tax is not paid.

Of course, in the taxation of incomes of *corporations* and *partnerships* there are occasions for *allocation* of income on a basis other than provided by a *contract*. The Commissioner, for tax purposes, limits salaries paid by corporations under employment contracts to "reasonable compensation" for services rendered. He does not disregard the contract entirely and the entire salary paid. This effectively prevents diversion of income from the corporation for tax purposes. The same principle should be applied to income from partnership, where the income is created "by the firm enterprise itself, that is, *the capital of the firm* and the labor and skill of its members employed in combination through the partnership relation in the conduct of the partnership business", just as is the case with corporations. If some of the partners render services to the partnership business where capital is involved and some do not, then *"reasonable compensation"* for such services should be allocated to such partners first and the remaining income distributed to all partners on the basis of their bona fide *ownership* interest in the partnership capital and business. This effectively prevents diversion of any element of personal service income for tax purposes. In this allocation it is not necessary to entertain any complicated economic notions as to how much of the income is attributable to services and how much is attributable to capital any more than such highly theoretical speculations are required for determination of reasonable compensation for services to a corporation. The only amount of *personal service income* which could be diverted to other parties in such cases would be the amount of the *"reasonable compensation" for such services* rendered to the partnership. Also, if the partnership agreement calls for a share of partnership income to some partners *in excess* of their *ownership interest*, their share of the income should be adjusted for tax purposes to the *actual ownership interest*, unless the excess represents *"reasonable compensation"* for services rendered, or other considerations of genuine value to the business. But in any event, the actual, bona fide *ownership interest* cannot be ignored and income should be taxed on the basis of such interest.

The right to transfer *the tree*—the property—or an interest therein, is beyond question. Diversion of income from the services of one of the joint owners, who sprays the tree and ploughs the land, to other owners of the tree can be easily prevented by adding "reasonable compensation" for such services to his contractual share of the fruit. This is the way Respondent prevents diversion of the income from the owners of the tree to the one who ploughs the land and sprays the tree, viz: by limiting the share agreed upon for such services to "reasonable compensation" therefor.

Respectfully submitted:



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APPENDIX

Internal Revenue Code.

Section 11. "There shall be levied, collected and paid for each taxable year upon the net income *of* every individual a normal tax — — — ."

Section 12. (b) "There shall be levied, collected and paid for each taxable year upon the surtax net income *of* every individual — — — ."

Section 22. (a) "General Definition—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from profession, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, *growing out of the ownership or use of or interest in such property;* also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

Section 181. "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

Section 182. "In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Section 183 (b)."

Section 3797. (a) (2) "The term "partnership" in-

cludes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

Constitution of the United States.

Amendment V. "No person shall — — — be deprived of — — — property, without due process of law; nor shall private property be taken for public use without just compensation."

Title 28. Section 347. U. S. C. A.:

(a) "In any case, civil, or criminal, in a circuit court of appeals, or in the Court of Appeals of the District of Columbia, it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether Government or other litigant, to require by certiorari, either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal."

Section 1141, Internal Revenue Code:

"The Circuit Court of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Board, except as provided in Section 239 of the Judicial Code as Amended, 43 Stat. 938 (U. S. C. Title 28, Sec. 346); and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme

Court of the United States upon certiorari, in the manner provided in Section 240 of the Judicial Code, as amended, 43 Stat. 938 (U. S. C. Title 28, Sec. 347).

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	6
Conclusion	12
Appendix	13

CITATIONS

Cases:	
Appel v. *Smith*, 161 F. 2d 121	8
Argo v. *Commissioner*, 150 F. 2d 67, certiorari denied, 326 U. S. 762	7
Belcher v. *Commissioner*, decided July 2, 1947	7
Benson v. *Commissioner*, 161 F. 2d 821	7
Blalock v. *Allen*, 151 F. 2d 927	7
Bradshaw v. *Commissioner*, 150 F. 2d 918	8
Camfield v. *Commissioner*, 154 F. 2d 1016	8
Commissioner v. *Harmon*, 323 U. S. 44	10
Commissioner v. *Tower*, 327 U. S. 280	6, 7, 8, 9, 10, 11, 12
Covington v. *Commissioner*, 103 F. 2d 201	7
Davis v. *Commissioner*, 161 F. 2d 361	7
Dawes v. *Allen*, 157 F. 2d 518	7
Dawson v. *Commissioner*, decided September 22, 1947	7
DeKorse v. *Commissioner*, 158 F. 2d 801	8
Doll v. *Commissioner*, 149 F. 2d 239, certiorari denied, 326 U. S. 725	8
Durwood v. *Commissioner*, 159 F. 2d 400	8
Earp v. *Jones*, 131 F. 2d 292, certiorari denied, 318 U. S. 764	8
Eisenberg v. *Commissioner*, 161 F. 2d 506	7
Ewing v. *Commissioner*, 157 F. 2d 679	8
Grant v. *Commissioner*, 150 F. 2d 915	8
Greenberg v. *Commissioner*, 158 F. 2d 800	8
Harrison v. *Schaffner*, 312 U. S. 579	10, 11
Hash v. *Commissioner*, 152 F. 2d 722, certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879	7
Heiner v. *Donnan*, 285 U. S. 312	9
Helvering v. *Clifford*, 309 U. S. 331	10, 11
Helvering v. *Eubank*, 311 U. S. 122	11
Helvering v. *Horst*, 311 U. S. 112	10
Hoeper v. *Tax Commission*, 284 U. S. 206	9

Cases—Continued — Page

Interstate Transit Lines v. *Commissioner*, 319 U. S. 590 — 11
Kasch v. *Commissioner*, 63 F. 2d 466, certiorari denied, 290 U. S. 644 — 7
Livie v. *Commissioner*, 155 F. 2d 728 — 8
Lorenz v. *Commissioner*, 148 F. 2d 527, certiorari denied, 327 U. S. 786 — 8
Losh v. *Commissioner*, 145 F. 2d 456 — 8
Lowry v. *Commissioner*, 154 F. 2d 448, certiorari denied, 329 U. S. 725 — 8
Lucas v. *Earl*, 281 U. S. 111 — 11
Lusthaus v. *Commissioner*, 149 F. 2d 232 — 7
Lusthaus v. *Commissioner*, 327 U. S. 293 — 6, 7, 8, 9, 10, 11, 12
Mauldin v. *Commissioner*, 155 F. 2d 666 — 7
Mead v. *Commissioner*, 131 F. 2d 323, certiorari denied, 318 U. S. 777 — 7
Miller v. *Commissioner*, 150 F. 2d 823 — 7
Morton v. *Thomas*, 158 F. 2d 574, certiorari denied, 330 U. S. 834 — 7
Schreiber v. *Commissioner*, 160 F. 2d 108 — 8
Schroder v. *Commissioner*, 134 F. 2d 346 — 7
Seibert v. *Commissioner*, 156 F. 2d 227 — 7
Seifert v. *Commissioner*, 157 F. 2d 719 — 7
Sewell v. *Commissioner*, 151 F. 2d 765, certiorari denied, 327 U. S. 783 — 7
Sewell's Estate v. *Commissioner*, 151 F. 2d 806, certiorari denied, 327 U. S. 805 — 7
Singletary v. *Commissioner*, 155 F. 2d 207 — 7
Supornick v. *Commissioner*, 150 F. 2d 110 — 8
Sweigard v. *Commissioner*, 149 F. 2d 646 — 7
Thomas v. *Feldman*, 158 F. 2d 488 — 7
Thorrez v. *Commissioner*, 155 F. 2d 791 — 8
Tinkoff v. *Commissioner*, 120 F. 2d 564 — 8
Tyson v. *Commissioner*, 146 F. 2d 50 — 8
Villere v. *Commissioner*, 133 F. 2d 905 — 7
Waldburger v. *Helvering*, 131 F. 2d 598 — 7
Walker v. *Commissioner*, 160 F. 2d 313 — 7
Welch v. *Helvering*, 290 U. S. 111 — 11
Wilson v. *Commissioner*, 161 F. 2d 556 — 7
Wilson v. *Commissioner*, 161 F. 2d 661 — 8

Statutes:

Internal Revenue Code:

Sec. 11 (26 U. S. C. 1940 ed., Sec. 11) — 13
Sec. 22 (26 U. S. C. 1940 ed., Sec. 22) — 13
Sec. 181 (26 U. S. C. 1940 ed., Sec. 181) — 13
Sec. 182 (26 U. S. C. 1940 ed., Sec. 182) — 13
Sec. 3797 (26 U. S. C. 1940 ed., Sec. 3797) — 14

Miscellaneous:

Treasury Regulations 103, Sec. 19.22(a)–1 — 14

In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 341

JOHN G. (J. G.) SCHERF, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

GEORGE H. BARNES AND ADA E. BARNES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 47–59) is reported at 7 T. C. 346. The opinion of the Circuit Court of Appeals (R. 195–199) is reported at 161 F. 2d 495.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 16, 1947. (R. 200.) Taxpayers'

petition for rehearing was denied June 17, 1947. (R. 209.) The petition for a writ of certiorari was filed September 12, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that business income attributed by taxpayers to their children under so-called partnership agreements was includible in taxpayers' respective gross incomes as defined in Section 22 (a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts found by the Tax Court (R. 47–57) may be summarized as follows:

In 1938 taxpayers[1] became equal partners in a pants manufacturing business conducted under the firm name of S & B Manufacturing Company. Scherf ran the office and attended to financial matters, while Barnes managed the manufacturing operations. The business had about 200 employees. At the close of 1939 the net book worth of the business assets was $32,321.30. (R. 48.)

[1] The term "taxpayers" whenever appearing herein has reference to petitioners John G. Scherf and George H. Barnes; Mrs. Barnes is a party only because she and her husband filed a joint return for the taxable year. (R. 47–48.)

Scherf had two sons, Paul and John, Jr.; Barnes had two daughters, Mildred and Ruth. In 1940, at the time of formation of the partnership here involved, Paul was 28, married, and employed by the Alabama Textile Products Company, a shirt and underwear manufacturing corporation of which his father was president and controlling stockholder. John, Jr., and Mildred were each 20 and attending college. Ruth was 18 and attended preparatory school. (R. 48, 49, 54.)

On May 16, 1940, taxpayers executed identical instruments of assignment transferring to each of their respective children, in consideration of love and affection, an undivided one-sixth interest in the S & B Manufacturing Company. On or about the same date taxpayers and their children executed a partnership agreement, dated as of January 1, 1940. After reciting the gifts the agreement provided that the partnership was to continue until dissolved by mutual agreement; that the business was to be conducted under the same name, at the same place, and with the same assets, as before; that the parties were to share equally in profits or losses; and that taxpayers were to be the "managing partners" and the children "investing partners," Scherf to have charge of financial matters and Barnes of manufacturing operations. Gift tax returns covering the transfers were filed. (R. 49–53.)

In assigning undivided interests in the business assets to their children, taxpayers intended, and the children understood, that the assets should remain in the business. The children contributed no capital to the business other than the interests donated to them by taxpayers. (R. 53, 58.)

After formation of the new partnership the business was conducted in the same manner as before. Scherf continued to manage the office and financial affairs, while Barnes continued to super vise manufacturing operations. Throughout 1940 (the taxable year) Paul continued in the employ of the Alabama Textile Products Company, and received a salary of $3,400 from that company for the year. He knew nothing about the operations of the S & B Manufacturing Company; up to the latter part of 1940 his activities were limited to learning about the business and keeping some personnel files, and he took no active part in the business during 1940. John, Jr. left college in September of 1940, became employed by the Alabama Textile Products Company, and received a salary from it of $312.97 in that year; he learned to operate a billing machine and did some billing for the S & B Company in 1940. Mildred and Ruth continued to attend school until 1943, but did some clerical work during their summer vacation in 1940. (R. 54–55.) None of the children contributed vital services during the taxable year, nor did any of them participate in management of the business. (R. 58–59.)

The books of the old partnership were not closed when the new partnership was formed, but were continued in use during the taxable year. A capital account for each child was set up on the old books when he or she made the first withdrawal of income. Mildred and Ruth each withdrew $200 in July 1940, $800 in September 1940, and $1,467.67 on December 14, 1940; the other parties each withdrew $2,467.67 on December 14, 1940. When the old partnership books were closed in January 1941, the capital account of each child was credited, as of January 1, 1940, with one-sixth of the net worth of the old partnership plus one-sixth of the 1940 net income of the business; the income shares so credited to the children were later adjusted to reflect a credit of only one-sixth of the 1940 net income allocable to the period subsequent to May 16, 1940, the date the new partnership was formed. (R. 56–57.)

The 1940 net income of the business was $36,213.42. In the partnership return for that year 136/365 of this amount was allocated to the old partnership (covering the period up to May 16, 1940) and 229/365 was allocated to the new partnership (covering the remainder of the year). The portion allocated to the old partnership was reported as distributable to taxpayers in equal one-half shares, and the portion allocated to the new partnership was reported as distributable to taxpayers and their children in equal one-sixth shares. In their individual tax returns for 1940

taxpayers and their children reported income from the business in accordance with such allocation. (R. 55–56.) The Commissioner determined that taxpayers were each taxable on one-half of the 1940 net business income, resulting in the deficiencies in controversy. (R. 57.) The Tax Court concluded that the children were not real partners during the taxable year (R. 57–59), and sustained the Commissioner's determination (R. 60–61). The Circuit Court of Appeals affirmed. (R. 195–199.)

ARGUMENT

There is no occasion for further review. This case is controlled by *Commissioner* v. *Tower*, 327 U. S. 280, and *Lusthaus* v. *Commissioner*, 327 U. S. 293, with which the decision below is in accord.

1. The question here is the same as in the *Tower* and *Lusthaus* cases, *supra*. This Court there held that (1) family partnerships erected upon gifts of business capital are without federal income tax significance, though valid under state law, if the arrangement produces no substantial change in the creation of the business income but merely a reallocation of the income within the donor's family; (2) whether the claimed partnership—so tested—has reality presents a question of ultimate fact for the Tax Court, whose determination is conclusive on appeal if supported by substantial evidence; and (3) unless the donee "invests capital originating with her or substantially contributes to the control and management of the

business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is justified in concluding that the donee is not a real partner for tax purposes. The Circuit Courts of Appeals have applied these principles in a variety of contexts and an impressive array of cases, both before and after *Tower* and *Lusthaus.*[2]

Properly addressing itself (R. 58) to the "basic question" of who really earned the business in-

[2] SECOND CIRCUIT: *Seifert* v. *Commissioner*, 157 F. 2d 719; *Seibert* v. *Commissioner*, 156 F. 2d 227; *Miller* v. *Commissioner*, 150 F. 2d 823; *Waldburger* v. *Helvering*, 131 F. 2d 598. THIRD CIRCUIT: *Eisenberg* v. *Commissioner*, 161 F. 2d 506; *Davis* v. *Commissioner*, 161 F. 2d 361; *Walker* v. *Commissioner*, 160 F. 2d 313; *Lusthaus* v. *Commissioner*, 149 F. 2d 232, affirmed, 327 U. S. 293; *Sweigard* v. *Commissioner*, 149 F. 2d 646. FOURTH CIRCUIT: *Wilson* v. *Commissioner*, 161 F. 2d 556; *Mauldin* v. *Commissioner*, 155 F. 2d 666; *Hash* v. *Commissioner*, 152 F. 2d 722, certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879. FIFTH CIRCUIT: *Benson* v. *Commissioner*, 161 F. 2d 821; *Belcher* v. *Commissioner*, decided July 2, 1947 (1947 C. C. H., par. 9308); *Mead* v. *Commissioner*, 131 F. 2d 323, certiorari denied, 318 U. S. 777; *Argo* v. *Commissioner*, 150 F. 2d 67, certiorari denied, 326 U. S. 762; *Sewell's Estate* v. *Commissioner*, 151 F. 2d 806, certiorari denied, 327 U. S. 805; *Sewell* v. *Commissioner*, 151 F. 2d 765, certiorari denied, 327 U. S. 783; *Dawes* v. *Allen*, 157 F. 2d 518; *Blalock* v. *Allen*, 151 F. 2d 927; *Morton* v. *Thomas*, 158 F. 2d 574, certiorari denied, 330 U. S. 834; *Singletary* v. *Commissioner*, 155 F. 2d 207; *Schroder* v. *Commissioner*, 134 F. 2d 346; *Villere* v. *Commissioner*, 133 F. 2d 905; *Covington* v. *Commissioner*, 103 F. 2d 201; *Kasch* v. *Commissioner*, 63 F. 2d 466, certiorari denied, 290 U. S. 644; cf. *Thomas* v. *Feldman*, 158 F. 2d 488. SIXTH CIRCUIT: *Dawson* v. *Commissioner*, decided September 22, 1947, not yet re-

come (*Commissioner* v. *Tower, supra,* pp. 283, 289), the Tax Court found that taxpayers' children contributed no capital other than what they contemporaneously received by way of gift from taxpayers, performed no vital services, and did not participate in management (R. 53–55, 58–59); in short, that during the taxable year "the business was continued in the same manner as before" (R. 54). The court below held that these findings were not merely supported but were demanded by the evidence (R. 199), and they are not in dispute. They amply warrant the Tax Court's conclusion (R. 58) that the donee-children were not real partners and that taxpayers earned, and hence were taxable, on the shares of business income attributed to the children. *Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra.*

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ported; *Lowry* v. *Commissioner*, 154 F. 2d 448, certiorari denied, 329 U. S. 725; *Lorenz* v. *Commissioner*, 148 F. 2d 527, certiorari denied, 327 U. S. 786; *Thorrez* v. *Commissioner*, 155 F. 2d 791; *Camfield* v. *Commissioner*, 154 F. 2d 1016; *Livie* v. *Commissioner*, 155 F. 2d 728; *Ewing* v. *Commissioner*, 157 F. 2d 679; *DeKorse* v. *Commissioner*, 158 F. 2d 801; *Greenberg* v. *Commissioner*, 158 F. 2d 800; *Schreiber* v. *Commissioner*, 160 F. 2d 108. SEVENTH CIRCUIT: *Appel* v. *Smith*, 161 F. 2d 121; *Tinkoff* v. *Commissioner*, 120 F. 2d 564; cf. *Wilson* v. *Commissioner*, 161 F. 2d 661. EIGHTH CIRCUIT: *Doll* v. *Commissioner*, 149 F. 2d 239, certiorari denied, 326 U. S. 725; *Supornick* v. *Commissioner*, 150 F. 2d 110; *Tyson* v. *Commissioner*, 146 F. 2d 50; cf. *Durwood* v. *Commissioner*, 159 F. 2d 400. TENTH CIRCUIT: *Earp* v. *Jones*, 131 F. 2d 292, certiorari denied, 318 U. S. 764; *Grant* v. *Commissioner*, 150 F. 2d 915; *Bradshaw* v. *Commissioner*, 150 F. 2d 918; *Losh* v. *Commissioner*, 145 F. 2d 456.

Here, as in the *Tower* and *Lusthaus* cases, every ingredient productive of the income in question—capital, services, and management—emanated from the taxpayers. While titular ownership of some of the business assets was shifted to the children (R. 49), and specified shares of the business profits were ascribed to them as "investing partners" (R. 52), taxpayers continued as before to create the income. The children became "partners" in name and on paper only.[3] Under familiar rules governing the scope of judicial review of Tax Court decisions, reiterated by this Court in the *Tower* and *Lusthaus* cases themselves with reference to the very question here presented, affirmance of the Tax Court's decision by the court below was clearly correct.

2. Taxpayers' assertion (Pet. 9–10) that the decision below subjects them to tax on income from property they no longer "owned", and is therefore in conflict with *Hoeper* v. *Tax Commission,* 284 U. S. 206, and *Heiner* v. *Donnan,* 285

[3] Not even the usual bare legal and accounting formalities were here fully observed. It does not appear that the old partnership between taxpayers was dissolved upon admission of their children as partners; the books of the old partnership were continued in use throughout the taxable year, and capital accounts were not set up for the children until they received an initial distribution of the profits. (R. 56.) Moreover, taxpayers did not distribute all of the income allocated to the children, but retained a substantial part of it in the business (R. 55–56); they thus continued to enjoy control over some of the income (as well as all of the corpus) of the partnership interests they purported to give away.

U. S. 312, begs the issue by assuming, contrary to the controlling decisions (*Commissioner* v. *Tower, supra; Helvering* v. *Clifford,* 309 U. S. 331; cf. *Harrison* v. *Schaffner,* 312 U. S. 579; *Helvering* v. *Horst,* 311 U. S. 112; *Commissioner* v. *Harmon,* 323 U. S. 44), that a gift of naked legal title to property suffices to insulate the donor from income tax. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided". *Commissioner* v. *Tower, supra,* p. 291. Equally unfounded is taxpayers' assertion (Pet. 10) of conflict with the *Tower* and *Lusthaus* cases; the Tax Court reached the same conclusion in this case as it did in those cases, and the evidentiary support for its conclusion is no more assailable here than it was there.

3. Taxpayers' elaborate argument (Br. 14–27) is essentially the same as that which this Court rejected in the *Tower* and *Lusthaus* cases. Inquiry into the reality of a family partnership is not, as they assume, to be confined to cases where the business income is derived exclusively from services, nor is it to be delimited by what portions of the income are attributed respectively to capital and services.[4] The situation here is no

[4] The unreality of the instant arrangement is accentuated by the fact that although taxpayers performed vital services and the children did not, apparently no compensation was deducted for taxpayers' services in computing the income shares ascribed to the children. The latter each purportedly

different from any other in which a taxpayer anticipatorily assigns his income. Whatever the legal cast of the arrangement, he does not escape the tax. It is immaterial whether the income be derived from services (*Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Eubank*, 311 U. S. 122), or from property of which he remains the substantial owner (*Harrison* v. *Schaffner, supra; Helvering* v. *Clifford, supra*), or, as here, from a blend of both sources (*Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra*). Had taxpayers simply and directly assigned portions of their future business income to their children, they unquestionably would remain taxable on the assigned income. That they circuitously reached the same result by means of a formally perfect partnership arrangement obviously does not produce a different tax result. Unless the donee-partners contribute new capital, or perform vital

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contributed as "investing partners" one-sixth of the $32,321.30 of the net business assets, or about $5,387 (R. 48–49, 50–51); the income they each reported for the period May 16, 1940, to December 31, 1940, amounted to $3,786.81 (R. 55–56)—a return within 7½ months of over 70% of their so-called investment. Even on taxpayers' postulate that they are taxable only on that portion of the business income derived from their services, they could not prevail, for they offered no evidence from which an apportionment could be made. And since taxpayers had the burden of proving the Commissioner's determination, presumptively correct, to be wrong (*Commissioner* v. *Tower, supra*, p. 286, fn. 4; *Welch* v. *Helvering*, 290 U. S. 111), in the absence of such evidence the entire deficiency must be deemed correct. Cf. *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 594.

additional services, or participate in management—admittedly not the case here—there is no change in the creation of the business income and, accordingly, no change in the tax incidence. To permit the tax consequences to turn upon the considerations stressed by taxpayers would sanction the very type of formalism which this Court in the *Tower* and *Lusthaus* cases refused to recognize as effectual to alter tax liability.

CONCLUSION

The decision below is correct. This case turns upon its facts and presents no question calling for further review. There is no conflict of decisions. The petition should therefore be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.
(26 U. S. C. 1940 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.
(26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss

of the partnership, computed as provided in section 183 (b).
(26 U. S. C. 1940 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctively expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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